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Report No. P-574

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## INTERNATIONAL DEVELOPMENT ASSOCIATION

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### REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED CREDIT TO THE

REPUBLIC OF KOREA

FOR A

SECOND RAILROAD PROJECT

November 29, 1967

## INTERNATIONAL DEVELOPMENT ASSOCIATION

### REPORT AND RECOMMENDATION OF THE PRESIDENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED CREDIT TO THE REPUBLIC OF KOREA FOR A SECOND RAILROAD PROJECT

1. I submit the following report and recommendation on a proposed credit in an amount in various currencies equivalent to U.S. \$11 million to the Republic of Korea.

#### PART I - HISTORICAL

2. In 1962, the Bank Group undertook its first lending operation in Korea extending a \$14 million IDA credit for a railway project to help finance the purchase of rolling stock included in the 1962-1966 investment program of the Korean National Railroad (KNR). The credit is fully disbursed and the project was satisfactorily completed.
3. In the following years Korea's economic policies, which had led to serious monetary instability and a decline in foreign exchange reserves, precluded any further lending by the Bank or IDA. Beginning in 1964, the Korean Government made determined efforts to improve the economic situation which brought about substantial increases in public and private savings, a slow-down in the rise of the price level, and an increase in foreign exchange reserves. In view of the Government's efforts the Bank/IDA in 1965 agreed to consider further operations and to sponsor, at the request of the Government, the establishment of a Consultative Group for Korea. A Consultative Group was formed at a meeting in Paris in December 1966.
4. In August 1966, the Government asked IDA for an \$11 million development credit to finance part of the 1967-1971 development program of KNR. This development program is based on the recommendations made by a transportation survey for the entire country and all modes of transport which was carried out in 1965/1966. The foreign exchange cost of this survey (\$388,000) was financed by the Bank under a technical assistance grant.
5. Negotiations took place in Washington between September 8 and September 25. The Government was represented by Mr. Moon Doh Chung, Assistant Minister, Economic Planning Board, and Mr. Tai Suk Oh from the Ministry of Transportation. The KNR was represented by Messrs. Hong and Park.
6. The above mentioned IDA credit of \$14 million has been the only Bank/IDA lending operation in Korea.
7. The World Bank Group has been instrumental in setting up the recently founded Korea Development Finance Corporation (KDFC). IFC has substantially negotiated an investment of about \$0.7 million equivalent in KDFC which, if approved, would be the first IFC investment in Korea. At the same time, the Bank negotiated a \$5 million loan to

KDFC and I expect to bring forward this loan together with the proposal for an IFC investment in KDFC within the next few weeks.

8. I also expect to present to the Executive Directors within the next few months a proposal to make a small development credit to finance the foreign exchange cost of highway feasibility studies and of studies related to the organization of highway planning and construction, and transport coordination in general.

## PART II - DESCRIPTION OF THE PROPOSED CREDIT

9.        Borrower:                      Republic of Korea
- Beneficiary:                Korean National Railroad
- Amount:                      The equivalent in various currencies of \$11 million.
- Purpose:                        To finance the foreign exchange cost of special type freight cars and of consultants' services.
- Amortization:                50 years, including a 10 year grace period. One-half of 1% of the principal amount will be repayable semi-annually for 10 years commencing December 1, 1977 and ending June 1, 1987; one and one-half of 1% of the principal amount repayable semi-annually thereafter until June 1, 2017.
- Service Charge:              Three-quarters of 1% per annum on the principal amount of the credit withdrawn and outstanding.
- Relending Terms:            25 years, including a 3 year grace period at an interest rate of 6% per annum.

## PART III - THE PROJECT

10.        An appraisal report entitled "Appraisal of a Second Railroad Project Korea" (TO-598a) dated November 21, 1967 is attached.

11.        Transportation requirements in Korea are predominantly met by the railway. Road transport has grown rapidly over the last ten years but remains confined to short distance traffic due to the lack of good roads. For this reason and because of the overall shortage of transport

capacity, problems of transport coordination have been minimal. However, the Government is beginning to take steps to cope with coordination problems which will become more pronounced in the future.

12. Both freight and passenger traffic have been growing at an average rate of 8% per annum between 1955 and 1966. KNR expects that freight traffic will grow about 11% per annum during 1967-1971 while passenger traffic would continue to grow at an annual rate of 8%. To meet this growth substantial investments are required.

13. The development program of KNR for 1967-1971, providing for expenditures totalling Won 57.4 billion (U.S. \$217 million equivalent), would increase the capacity of the railway sufficiently to meet the expected traffic growth and is considered sound. The project consists of the first three years of KNR's development program covering construction of new lines, increased station and line capacity, track and structure improvements, and the acquisition of motive power and rolling stock. The total cost of the project is estimated at about Won 36.3 billion (U.S. \$137 million equivalent) with a foreign exchange component of about U.S. \$40.3 million equivalent. The proposed IDA credit and existing or proposed loans from other countries would provide the foreign exchange required for the project. Contracts to be financed out of the proceeds of the proposed credit would be awarded on the basis of international competitive bidding.

14. The proceeds of the proposed credit would be used to finance the import of 600 hopper cars required to meet an expected increase in coal traffic by about 25% and of 450 tank cars to provide for the expected doubling of the volume of oil traffic over the project period. In view of the urgent need for the equipment, contracts for the cars have already been awarded. In placing these contracts, KNR observed the Association's requirements concerning procurement. Expenditures have not been incurred yet by KNR under these contracts.

15. Coal handling facilities, particularly in the Seoul area, do not permit at present the most economical use of coal cars. The Government and the coal industry are making efforts to correct this situation and the Government has agreed to employ consultants to study and advise on this problem. The foreign exchange cost of the consultants would be financed under the proposed credit. Because of the pressing need for a solution to the problems of coal traffic employment of the consultants satisfactory to the Association, would be a condition of effectiveness of the credit.

16. Until 1963, KNR was a bureau in the Ministry of Transportation. Following a requirement of the 1962 Credit Agreement, KNR was established in 1963 as a separate entity within the Ministry of Transportation with its own budget and accounting under an independent railway manager appointed by the Government. The Government has now decided that KNR should be organized as an autonomous entity and has set up a committee to study the problems involved. This will give

KNR more authority and flexibility in its operations, especially with respect to the allocation of funds within its budget, staffing and wage policies, and tariff policies.

17. At present, the KNR management still suffers from a lack of senior qualified engineering, economic and accounting staff. Until this deficiency can be made up by recruitment from universities, KNR's management must rely extensively on the advice from consultants in carrying out its development program. Consultants to advise on the use and preparation of statistics, traffic costing, the maintenance of rolling stock, and the planning and design of marshalling yards will be employed by KNR and the foreign exchange cost of these consultants is provided for under the proposed credit.

18. KNR's financial position is sound. More than two-thirds of the funds required for the 1967-1971 development program will be generated by the operations of the railways. Rates of return have been low in the past because tariffs were low and increases in recent years have not fully offset increases in costs, due mainly to increased wages and salaries. The Government proposes to increase passenger fares by 50% and freight rates by 30% not later than January 1, 1968. On this basis, the forecast of income and expenditure over the period 1967-1971, taking into account substantial rises in wages and salaries, shows rates of return of about 5% over the years 1968-1971. The Government and KNR have agreed to take the necessary steps to maintain and improve further on this level of return.

#### PART IV - LEGAL INSTRUMENTS AND AUTHORITY

19. The draft Credit Agreement between the Republic of Korea and the Association and the Recommendation of the Committee provided for in Article V, Section 1(d) of the Articles of Agreement are being distributed to the Executive Directors separately. The draft Credit Agreement generally follows the pattern of Agreements for projects of this type and is similar to the previous Agreement providing for a credit for railways in Korea.

#### PART V - THE ECONOMY

20. A report entitled "The Economy of Korea" (FE-55a) dated June 17, 1966, in eight volumes was distributed to the Executive Directors; Volumes I-IV and VI-VIII were distributed on June 27, Volume V was distributed on November 4, 1966. The report noted that the implementation of appropriate fiscal and monetary policies had reduced the monetary instability which marked the years 1962-1964 and had accelerated the growth of capital formation, production and exports. It concluded that the prospects for further rapid growth were favorable provided growth of the domestic savings rate and of financial assistance from abroad continued.

21. An economic mission which recently returned from Korea was favorably impressed by the performance of the Korean economy. The economic growth has further accelerated in 1966 and 1967. The increase of GNP in real terms in 1966 amounted to 13.4% and, in spite of adverse weather conditions affecting part of the grains production, GNP growth is expected to exceed 10% in 1967. The leading sector is manufacturing where the growth rate has recently exceeded 20% a year. Most of the rapid growth of manufacturing is connected with the expansion of exports, which rose from \$175 million in 1965 to \$250 million in 1966 and will probably reach \$350 million in 1967. This phenomenal increase in exports - of a wide variety of light industrial projects sold in a large number of developed countries - is due to the ability of Korean entrepreneurs, technicians and workers, and the wholehearted support of the Government. Another favorable factor of recent years is the large foreign exchange earnings (mostly services and remittances) as a result of the Viet Nam conflict. The manufacturing boom is exerting a strong pull on the output of the construction industry and the services sectors. Recently a power shortage has arisen. Despite a large investment on the expansion of power facilities, the shortage may impose a restraint on the growth of manufacturing production in at least part of 1968. In order to overcome similar existing bottlenecks, it is necessary to expand and improve transportation facilities in Korea.

22. The upsurge of activity is accompanied by a sharp rise in gross investment which has risen from 14.7% of GNP in 1965, to 21.7% in 1966 and which is expected to rise to 22.4% in 1967. A major part of the increase in investment is being financed by increased domestic savings of the Government and the private sector. Stepped-up tax collection, increases in public utility rates and restraint in current expenditures have led to a sharp increase in public savings. The reduction of monetary instability in recent years and the generally favorable development of the economy have greatly favored an increase in private sector savings.

23. The recent acceleration of the growth of the economy has led the Government to believe that economic growth can be maintained at a very high level. The Government's objective for 1968 is a GNP growth rate of 10% in real terms. In view of favorable demand conditions at home and abroad, and a large increase in productive capacity from investments currently being undertaken, this objective of the Government may be feasible provided power and transportation bottlenecks do not put too much restraint on the economy. The Government is determined to stave off the danger of financial instability inherent in very rapid economic growth by following the stabilization policies outlined in agreements with the Fund and the United States.

24. Despite more savings at home, the need for foreign capital remains large. United States grant assistance and low interest long-term loans, mainly from the United States and Japan, are being supplemented by a large amount of foreign suppliers' credits. Indebtedness, especially to foreign equipment suppliers, is rising

rapidly but with debt service averaging about 9% of prospective foreign exchange earnings, it is still manageable. The country could stand some additional debt on conventional terms; however, to prevent an undue increase in debt service obligations in the future and in view of the low per capita income of \$113, it appears desirable that a large part of foreign assistance be on concessional terms.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

25. I am satisfied that the proposed credit would comply with the Articles of Agreement of the Association.

PART VII - RECOMMENDATION

26. I recommend that the Executive Directors adopt the following resolution:

RESOLUTION NO.

Approval of Credit to Republic of Korea in an amount  
equivalent to U.S. \$11 million

RESOLVED:

THAT the Association shall grant a Development Credit to the Republic of Korea in an amount in various currencies equivalent to eleven million United States dollars (U.S. \$11,000,000), to mature on and prior to June 1, 2017, to bear a service charge at the rate of three-fourths of one percent ( $3/4$  of 1%), and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Development Credit Agreement (Second Railroad Project) between the Republic of Korea and the Association which has been presented to this meeting.

Attachment

George D. Woods  
President

November 29, 1967